

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
INTERNAL RELATIONAL PROGRAM**

April 15, 2002

This Policy is effective immediately upon adoption.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Internal Relational Program ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the U.S. capital markets.

II. STRATEGIC OBJECTIVE

Broadening the opportunity set of the System's investment portfolio for achieving investment returns not available in traditional public markets investments is the strategic objective of the Internal Relational Program.

The Program shall be managed to accomplish the following:

- A. Enhance the System's long-term total return.
- B. Hedge against long-term liabilities.
- C. Provide diversification to the System's overall investment program.
- D. Enhance the System's Corporate Governance Program.
- E. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending the Policy. The Committee delegates the responsibility for administering the

Program to the Investment Staff through the Delegation of Authority (Delegation Nos. 89-13 and 95-50).

B. The **System's Investment Staff's** ("the Staff") duties include, but are not limited to, the following:

1. Developing and recommending the Policy to the Investment Committee.
2. Developing and maintaining a procedures manual, subject to periodic review and updating, that outlines Staff operational procedures used in implementing this Policy.
3. Implementing and adhering to the Policy.
4. All aspects of portfolio management including monitoring, analyzing, and evaluating performance relative to the appropriate benchmark. In managing the Internal Relational Portfolio, staff will work cooperatively with external partners specific to each investment. Staff will be responsible for identifying potential partners, and presenting potential partners to the Investment Committee before executing an agreement with them.

C. The **General Pension Consultant** (the "General Pension Consultant") is responsible for monitoring and evaluating the program's performance relative to the applicable benchmark and the Policy. The General Pension Consultant shall report to the Investment Committee on a quarterly basis, in accordance with its contract.

IV. PERFORMANCE OBJECTIVE

The Internal Relational Program is expected to outperform the custom CalPERS Wilshire 2500 Index by at least 200 basis points. Due to the concentrated nature of the Internal Relational Portfolio, it is expected to have a higher overall risk level.

V. INVESTMENT APPROACHES, SELECTION, AND PARAMETERS

A. Approaches

1. CalPERS' Internal Relational Portfolio will be an internally managed active equity program based on fundamental analysis and corporate governance. The portfolio will take concentrated positions in selected companies. Combined

positions between CalPERS and its external partner may not exceed 25% of a company's market capitalization without prior Investment Committee approval.

2. The Program will be implemented in partnership with external managers. Each investment will be made under a letter agreement with a partner, such that the partner will be required to take a significant equity position consistent with CalPERS' stake.
3. The strategy of the Internal Relational Program will focus on unlocking intrinsic value in under-performing, publicly traded U.S. companies. The companies will have a generally strong fundamental business model, but are under-performing their peers due to management or board related issues. In cooperation with our external partner, CalPERS' staff will work with the company's management, Board of Directors, and other shareowners to build a consensus identifying the deficiency and the means to correct it. Tactics employed to address under-performing companies will be consistent with CalPERS' U.S. Corporate Governance Core Principles and Guidelines.

B. Investment Selection

1. CalPERS and the external partner will source potential investment ideas separately. It is anticipated that initially, a majority of the potential investments will be identified by the partner(s). CalPERS will continue to develop its internal expertise to identify potential investments under this strategy. CalPERS' primary internal source of potential investments will be through value and governance screens developed in the Corporate Governance Unit. Potential investments may include current, previous, or potential Focus List companies. However, it is expected that the number of Focus List companies that will be held in the Internal Relational Portfolio will be minimal.
2. Initial due diligence will be performed by the partner and by CalPERS independently.
3. Viable candidates for this program will be discussed informally between the partner (or potential partner) and CalPERS. Those potential investments warranting further review will be fully analyzed by the partner. CalPERS will conduct its own research on potential investments, but a

complete analysis will be completed by the partner regardless of the analysis performed by CalPERS' internal staff. In cases where CalPERS is considering an investment with a new partner, staff will present the partner to the Investment Committee before executing any agreement under this program.

4. CalPERS staff will consult with CalPERS' internal and, as appropriate, external counsel before executing each agreement.
5. CalPERS and the partner will make a joint decision to invest in the company and will finalize a strategy specific to the investment for realizing long-term value.

C. Investment Parameters

1. CalPERS' Internal Relational Portfolio has been approved at an initial funding level of \$500 million. The Portfolio is not to exceed \$500 million on a cost basis without prior approval of the Investment Committee. The Portfolio may exceed \$500 million on a market value basis.
2. CalPERS' Internal Relational Program is limited to U.S. publicly traded equity securities.
3. CalPERS' Internal Relational Portfolio shall be internally managed, and only simple letter agreements will exist between CalPERS and its partner(s). No management fees shall be applicable. Incentive fees may be used on a case by case basis, and shall be negotiated by staff and included in the letter agreement if applicable.
4. Expenses specific to each investment will be shared between CalPERS and its partner on a pro-rata basis. Estimated expenses will be analyzed as part of the investment decision specific to each proposal.
5. Due to the nature of relational investing, many investments under this program will involve taking substantial positions, both in terms of dollars invested and our holdings as a percentage of the companies' outstanding shares. At times, investments may fall under group rules for purposes of Security and Exchange Commission (SEC) Regulation 13(d), and will have filing requirements under this regulation.

6. Staff will provide a transaction report to the Investment Committee as each investment under this program is completed (when CalPERS has taken its initial position).

VI. BENCHMARKS

CalPERS' Internal Relational Portfolio shall be benchmarked against the CalPERS Custom Wilshire 2500 Index.

VII. GENERAL

- A. This Policy contains a glossary of terms in Part VIII. of this document.
- B. Staff, consultants, or other participants as appropriate shall base all calculations and computations on market value as recorded by the System's Custodian.

VIII. GLOSSARY OF TERMS

The following Glossary of Terms contains definitions also referenced in the System's Master Glossary of Terms.

CalPERS Custom Wilshire 2500 Index – The Wilshire 2500 Index, excluding Real Estate Investment Trusts (REITS) and tobacco stocks, and with dividends reinvested. The Wilshire 2500 comprises the top 2500 securities of the Wilshire 5000 Index, excluding REITS and tobacco stocks, based on market capitalization, and reconstituted annually. The Wilshire 5000 is an index that measures the performance of all U.S. headquartered equity securities with readily available price data.

Corporate Governance Funds – These are funds that effect changes in both the corporate governance and operating policies of public companies with the expectation of improved stock price performance.

Custodian – A bank or other financial institution providing the custody of stock certificates and other assets of an institutional investor.

External Partner – An external manager who has executed a letter agreement with CalPERS under our Internal Relational Program. Each letter agreement will be specific to each investment.

Letter Agreement – An agreement between CalPERS and its external partner specific to each investment made under the internal Relational Program. The agreement will include items specific to the investment,

such as purchasing and selling shares, reporting requirements, expenses, confidentiality, and termination.